

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Baugh Analyst: Colin Stevens Bill Number: AB 2552
Related Bills: AB 2311 (1997/98) Telephone: 845-3036 Amended Date: 8/24/98
Attorney: Doug Bramhall Sponsor: _____

SUBJECT: Vehicle Smog Check Station Dynamometer and Equipment Credit

SUMMARY OF BILL

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would allow two credits to taxpayers that own and operate a smog check station:

(1) a credit equal to the cost, less certain amounts, for the purchase or lease of a dynamometer and related equipment necessary to comply with Smog Check II regulations. A maximum \$50,000 credit would be allowed for each dynamometer to a taxpayer who owns and operates a smog check station. The credit would be available only if a policy, regulation, statute, initiative, or executive order is adopted prior to January 1, 2005, that reduces the number of vehicles subject to testing by 25% or more and the smog check station thereafter ceases performing smog checks; and

(2) a credit for additional enhancements in excess of \$5,000 over the life of the equipment which are required by state policy, regulation, statute, initiative, or executive order.

Under the Health and Safety Code, this bill also would make other changes to the Smog Check II program. These provisions are not discussed as they are not administered by the department.

SUMMARY OF AMENDMENT

The August 24, 1998, amendments struck out the prior version of the bill relating to insurance taxation and inserted the provisions discussed in this analysis.

EFFECTIVE DATE

As an urgency statute, this bill would take effect when enacted. However, the credit for the purchase of a dynamometer would not become operative unless and until the State Air Resources Board (CARB) makes certain findings discussed in this analysis and notifies the Franchise Tax Board of those findings. This credit potentially would last be available for the 2004 year. The credit for additional enhancements would apply to taxable or income years beginning on or after January 1, 1998, and before January 1, 2005.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ <u>X</u> PENDING

Department Director

Date

John W. Davies

9/21/98

LEGISLATIVE HISTORY

SB 629 (Ch. 1, Stats. 1994), AB 1914 (1997), AB 1492 (Ch. 803, Stats. 1997), AB 2311 (1998).

BACKGROUND

Since 1984, the Bureau of Automotive Repair (BAR) has administered a program requiring most licensed motor vehicles in the state (except motorcycles, diesel and off-road vehicles) to pass a smog test. Under the program as originally enacted, the smog test was required either when the vehicle was sold or every two years when the vehicle was registered, depending upon the area of the state in which the vehicle was registered. Individual garages licensed by the BAR performed the smog checks.

The 1990 federal Clean Air Act mandated that all states develop a vehicle inspection and maintenance program with certain requirements. In 1994, SB 629 (Ch. 1, Stats. 1994) provided the legal basis for the BAR to administer Smog Check II. The Smog Check II program designates the frequency of smog checks based on an area's smog levels. Areas with the most serious air quality problems are classified as "enhanced areas," and most vehicles in these areas are required to be tested every two years. However, vehicles in many rural areas are required to be smogged only upon a change of ownership.

AB 1492 (Ch. 803, Stats. 1997) altered many provisions of Smog Check II and, among other things, exempted from biennial smog check requirements vehicles over 25 years old and new vehicles (for their first four years after purchase).

Smog Check II requires that testing stations in enhanced areas use new equipment meeting a different standard (known as BAR-97), which tests for oxides of nitrogen as well as other emissions. Vehicles in enhanced areas must be tested on a dynamometer, which tests an engine under load and more accurately measures a vehicle's emissions under normal driving conditions. As a result of the BAR-97 standard, testing stations in enhanced areas will no longer be able to use the older equipment known as Bar-90 and instead must purchase new equipment.

SPECIFIC FINDINGS

Federal and state laws allow a variety of tax credits and deductions designed to promote or influence specific taxpayer behavior. Neither federal nor state laws allow a tax credit for the cost of purchasing equipment needed to perform smog checks. However, to the extent smog check equipment is necessary to conduct a taxpayer's business, taxpayers would be allowed a depreciation deduction as described below.

Federal and state laws allow a depreciation deduction for the cost of purchasing smog check equipment, provided that equipment is used in the conduct of the taxpayer's business. Under federal law, smog check equipment is depreciable over a five-year period. Smog check equipment is depreciable over a five-year period for the PITL and a ten-year period for B&CTL. In addition, in lieu of depreciation, existing **federal and state laws** allow taxpayers with a sufficiently small amount of expenditures on depreciable property to elect to deduct as an expense (subject to limitations) the cost of qualified property placed in service for the taxable year. Under **federal law and state PITL**, the limit is \$19,000 in 1999; \$20,000 in 2000; \$24,000 in 2001; \$24,000 in 2002; and \$25,000 in 2003 and

thereafter. In general, qualifying property is defined as depreciable tangible property that is purchased for use in the active conduct of a trade or business. The allowed deduction is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000.

The B&CTL does not conform to federal expensing treatment. However, the B&CTL allows a taxpayer to deduct 20% of the cost of tangible property in the first year the property is placed in service. The maximum amount of "additional" first year depreciation is \$2,000. In addition, in certain areas such as enterprise zones (EZs) and local agency military base recovery areas (LAMBRAs), corporate as well as personal income taxpayers doing business in these areas may elect to treat the cost of qualified property within the area as an expense in the year placed in service.

Credit #1-Credit for the purchase or lease of a dynamometer and related equipment

Under the PITL and the B&CTL, **this bill** would allow a credit equal to a qualified amount, for the purchase or lease of a dynamometer and related equipment necessary to comply with Smog Check II regulations. The total amount of credit for each dynamometer and related equipment could not exceed \$50,000.

The "qualified amount" would be equal to the adjusted cost, as defined, multiplied by an applicable percentage. The applicable percentage would be 86% for the taxable or income year in which the applicable date occurs, 71% for the following year, 57% the following year, 43% the following year, 29% the following year, and 16% for the fifth taxable year following the applicable date.

The "applicable date" would mean either:

- for equipment purchased by the taxpayer, the date on which the dynamometer and related equipment is placed in service, or
- for equipment leased by the smog check operator, the date on which the lease term commences.

The "adjusted cost" would mean the cost paid or incurred by the owner of a smog check station, in order to comply with requirements of Smog Check II. The adjusted cost would include the cost of installing a dynamometer and related equipment, any permits necessitated by the installation of the equipment and that portion of any service maintenance contract purchased but not used. However, the following amounts would be subtracted:

- Ten thousand dollars (\$10,000);
- An amount equal to an unspecified percentage of all deductions otherwise allowed or allowable under state law.

The amount of a service contract purchased but not used would be determined by multiplying the total prepaid amount of a service maintenance contract by a fraction.

The credit would be allowed only to the taxpayer who is eligible to take depreciation with respect to the dynamometer and related equipment.

Taxpayers claiming this credit would be required to:

- Retain a copy of any documentation or certifications provided by regulatory agencies or manufacturers of dynamometers that verify that the equipment meets the requirements of the bill; and
- Provide the documentation to the FTB upon request.

Any unused credit may be carried forward for six years until exhausted.

The general rules in state law regarding the division of credits among taxpayers who share in the expense would apply, and the credit would not reduce regular tax below tentative minimum tax for alternative minimum tax (AMT) purposes.

This credit would become operative only if a policy, regulation, statute, initiative or executive order enacted or adopted prior to January 1, 2005, by any agency of the State of California, decreases by 25% or more the number of vehicles subject to testing under Smog Check II. The CARB would be required to notify the FTB of that finding by August 31 of the year in which the finding is made in order for the credit to take effect during that taxable or income year. If the CARB notified the FTB of a finding after August 31, the credit would become operative the following January 1.

If a taxpayer elects to claim the credit allowed by this bill, that taxpayer would be prohibited from issuing further smog certificates.

Credit #2- Credit for Additional Enhancements

Under the PITL and the B&CTL, **this bill** would allow a credit equal to the amount paid or incurred for qualified costs by a taxpayer that operates a smog check station for additional enhancements required by state regulations, statute, initiative, or executive order in order to comply with Smog Check II testing requirements.

For purposes of **this bill**:

"Additional enhancements" means an alteration or addition required by state regulations, statute, initiative, or executive order in order to comply with Smog Check II testing requirements, but does not include normal maintenance costs or the cost of alterations or additions that are not required to comply with Smog Check II. No credit would be allowed for the replacement of a dynamometer or related equipment.

"Qualified costs" means any portion of costs paid or incurred during a year that exceed a base amount. The "base amount" would be equal to \$5,000 plus any amount in excess of \$5,000 for prior years.

The credit would be allowed only to the taxpayer who is eligible to take depreciation with respect to the dynamometer and related equipment.

Any unused credit may be carried forward for six years until exhausted.

The general rules in state law regarding the division of credits would apply, and the credit would not reduce regular tax below tentative minimum tax for alternative minimum tax (AMT) purposes.

Policy Considerations

Fundamentally this bill authorizes the credit for the purchase of a dynamometer only if a future event of uncertain likelihood occurs, i.e., a reduction in the number of vehicles required to receive a smog certificate under Smog Check II. Also, the credit would be allowed only if the taxpayer no longer issues smog certificates, so this credit may only be claimed by taxpayers who go out of this business, presumably because of the reduction in the state's smog certification requirements.

This bill would not prevent a taxpayer from claiming the credits allowed under this section in addition to other credits to which the taxpayer also may be entitled, such as the enterprise zone credit, creating the opportunity for a taxpayer to claim multiple tax benefits for the same expense.

Implementation Considerations

Implementing this bill would not significantly impact the department's programs and operations.

Technical Considerations

The credit for the purchase or lease of a dynamometer and related equipment incorrectly refers to Section 6 as the section containing findings. Amendments 1 and 3 would correctly identify Section 20 as the section which would trigger the credit's operation.

The PITL credit for the purchase or lease of a dynamometer should be allowed against the net tax, rather than against "the amount of" net tax. Amendment 2 would delete the unnecessary language.

Line 39 of page 32 is missing the word "year" in describing an income year. Amendment 4 would correct this error.

FISCAL IMPACT

Departmental Costs

This bill is not expected to result in significant costs to the department.

Tax Revenue Estimate

Based on the discussion below, the following table reflects the estimated impact of this bill:

Estimated Revenue Impact AB 2552					
Assumes Findings Made 4/1/99					
For Taxable or Income Years Beginning 1/1/99					
(In Millions)					
1998-9	1999-0	2000-01	2001-02	2002-03	2003-04
(\$2)	(\$25)	(\$15)	(\$15)	(\$15)	(\$10)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this proposal.

Tax Revenue Discussion

The revenue impact of this bill would be determined by the number of dynamometers and related equipment purchased for the enhanced Smog Check program, the cost of dynamometers, alteration or addition to a dynamometer, and related equipment, and the available tax liabilities of taxpayers claiming the credits.

Since no percentage was specified in the bill, for purposes of this estimate, it was assumed that the State Air Resources Board would make their finding on or about April 1, 1999, and that 100% of all deductions otherwise allowed or allowable would be used for calculating the "adjusted cost." If the percentage of all deductions otherwise allowed or allowable is less than 100%, the above revenue loss would increase.

This estimate was developed in the following steps. First, according to the California Inspection and Maintenance Review Committee, it is estimated that approximately 3,500 shops will have purchased 4,500 units of Bar-97 equipment with approximately 20% of the units purchased prior to January 1, 1998. Second, according to the same source, the cost of Bar-97 equipment plus installation is estimated to be approximately \$60,000. This cost does not include interest payments on loans; it is assumed that interest for equipment loans does not qualify as an equipment cost. Third, due to insufficient tax liabilities and the tentative minimum tax interaction, it was assumed that approximately 60% of the credits generated would be used over a period of six years.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2552
As Amended August 24, 1998

AMENDMENT 1

On page 28, line 14, strike "section 6" and insert:

section 20

AMENDMENT 2

On page 28, line 16, strike "amount of"

AMENDMENT 3

On page 32, line 24, strike "section 6" and insert:

section 20

AMENDMENT 4

On page 32, line 39, after "income" insert:

year